I. UPDATE ON INSTRUMENTALITIES AND LESSENING THE BURDENS OF GOVERNMENT

1. Introduction

This topic updates a more extensive treatment of the subject which may be found at Topic L., Instrumentalities - Lessening the Burdens of Government on pages 197 through 223, of the 1984 CPE Book.

At present, instrumentality cases must be referred into the National Office. IRM 7664.31(3) states:

> (3) Due to the question of exempt status and deductibility of contributions to instrumentalities of the United States, and instrumentalities of states or political subdivisions, all exemption applications submitted under IRC 501(c)(1) and 501(c)(3) from these types of organizations shall be referred to the National Office for consideration.

Lessening the burdens of government cases are no longer subject to National Office referral. IRM 7664.31(5) was revised on March 15, 1985, (MT 7600-54) to delete the requirement of referral of such cases to the National Office. The reason for the deletion was that with the publication of Rev. Ruls. 85-1, 1985-1 C.B. 177, and 85-2, 1985-1 C.B. 178, adequate precedent existed for the resolution of these cases in the field. These revenue rulings will be discussed in the lessening the burdens of government section.

2. Instrumentalities

A. Current Standards

As indicated in the 1984 CPE article, Rev. Ruls. 55-319, 1955-1 C.B. 119, and 60-384, 1960-2 C.B. 172, continue to provide the basic standard for exemption of instrumentalities under IRC 501(c)(3). That standard is two-part: (1) the instrumentality must be a separately organized entity, and (2) the organization must not have any powers inconsistent with those described in IRC 501(c)(3). The form of organization may be a trust, association, or corporation. The entity may be a corporation under a special act of incorporation of the state legislature, the state

for-profit business corporation act, the nonprofit business act of the state, or it may be a de-jure corporation created under local ordinance by a subdivision of the state.

Because of the diversity of organizational forms for instrumentalities, including corporations created by local ordinance pursuant to a delegation of the state's incorporating power to a local subdivision of government, EO Specialists should not expect to find an organizational document whose language even remotely approximates that of the model language for corporations in Publication 557. Also, EO Specialists should be aware that, as a practical matter, such organizational documents may be impossible to amend. In order to meet the "separate entity" test, it is ordinarily sufficient if some organizational document exists and that the document, on its face, creates an entity that is separate and apart from the creating government authority. However, in rare cases, it might be appropriate to ignore declarations of corporate existence of entities created at the urging of public officials or a public agency, especially where the entity is entirely subservient to the wishes of the officials or the agency. Finally, the organizational document should be closely read to determine the organization's purposes, the use or dedication of its assets, and what will happen to those assets upon dissolution.

The second part of the two-part test is the requirement that the entity not have any prohibited powers. The second part of the test is derived from the requirement that a 501(c)(3) organization be organized and operated exclusively for one or more of the enumerated purposes such as religious, charitable or educational. Obviously, a government is not itself engaged exclusively in charitable, educational, etc. activities, even though many of its functions parallel those of the private charitable sector. Thus, to the extent that a government establishes a "separate" entity to engage in typical charitable activities, it may or may not permit that separate entity to exercise powers typically reserved to the sovereign.

To the extent the government permits that separate entity to exercise some of its sovereign powers, the separate entity might not be viewed as engaging exclusively in charitable, educational, etc. activities.

Thus, in meeting this second test, it is necessary that the organization not exercise a power that is in the exclusive province of the government itself. Such might include war powers, power of appropriation of private property and conscription of private citizens in a general public emergency, the subpoena power, the power of eminent domain, the power of taxation, and the police powers. However, eminent domain was found to be a power also given to many

nongovernmental entities such as colleges, hospitals, and electric or other public utilities. Thus, it was recognized in Rev. Rul. 67-290, 1967-2 C.B. 183, that the power of eminent domain was not a basis for differentiation between instrumentalities that qualified for exemption under IRC 501(c)(3) and those that did not. Likewise, the mere power to set a tax rate, as opposed to an actual imposition or levy of taxes, was insufficient to indicate that an instrumentality was not entitled to IRC 501(c)(3) status. (See Rev. Rul. 74-15, 1974-1 C.B. 126, and compare it with the conclusion reached on the general issue of exercise of governmental powers in Rev. Rul. 74-14, 1974-1 C.B. 125.) In Rev. Rul. 74-14, the subpoena power, the power to compel testimony on pain of imprisonment for civil contempt, was found to be the exercise of the police power of the state, and, therefore, the entity did not qualify for exemption. There is an exception even in this area, however. Some police powers, such as the power to preserve order and provide for public safety within the confines of the entity's own real property, such as policing and traffic control on the campus of a public university, may on the basis of specific facts and circumstances be insufficient to constitute the exercise of the state's police power under the second part of the two-part test. See Rev. Rul. 77-165, 1977-1 C.B. 21.

Therefore, aside from the well-established rule that the subpoena power is a police power, the facts and circumstances of each case must be carefully examined by the EO Specialist to determine the existence of a proscribed power. The mere existence of some governmental power: eminent domain, tax-rate setting, or policing within confines of a college, may not be inconsistent with IRC 501(c)(3) status, unless the power in question is a substantial and extensive regulatory or enforcement power, equivalent to the police power of the state.

B. Indian Tribes

Indian tribes and related entities and activities have always presented difficult problems of classification for tax purposes. Are they a semi-sovereign political subdivision not subject to tax, an entity whose income is not subject to tax under section 115, or an exempt organization under section 501? Occasionally, the EO Specialist will receive an application for exemption from an entity closely related to an Indian tribe which performs either an educational, historic preservation, or cultural activity. The specialist should carefully examine such application to determine whether the entity is so closely related to the tribal government that it performs an essential government activity. If so, then the organization cannot qualify for exemption under IRC 501(c)(3). Rather, its

exemption from federal income taxes rests on it being a subdivision of the tribal government itself.

For tax purposes, the status of Indian tribal governments as instrumentalities was, prior to the enactment of IRC 7871, somewhat ambiguous, although historically Indian tribes have always been regarded as semi-sovereign states and, therefore, not taxable entities. Compare Rev. Ruls. 67-284, 1967-2 C.B. 48, and 74-179, 1974-1 C.B. 279, on the conflicting rationales dealing with the non-taxability of Indian tribes. Congress in The Indian Tribal Governmental Tax Status Act of 1982, P.L. 97-473, 96 Stat. 2605, as amended by P.L. 98-21, 97 Stat. 65, added IRC 7871. This Code section was made permanent by P.L. 98-369, 98 Stat. 494, The Deficit Reduction Act of 1984. The Code section provides that certain Indian tribal governments will be treated as a state for federal tax purposes. Rev. Proc. 83-87, 1983-2 C.B. 606, and Rev. Proc. 84-36, 1984-1 C.B. 511, provide lists of the tribal governments and the subdivisions of the tribal governments. The procedure by which such governments or their subdivisions request determination of their status is set forth in Rev. Proc. 84-37, 1984-1 C.B. 513. Note that the jurisdiction for such determinations is with CC:IND:S, in the National Office. In the event that the EO Specialist encounters an application from an Indian tribal entity believed to be within IRC 7871, and a determination is made that denial of IRC 501(c)(3) status is appropriate, the denial should make reference to the fact that a formal determination of tribal status under IRC 7871 may be requested pursuant to Rev. Proc. 84-37, supra. In addition, the language in IRM 7668.3(1) should be added to the denial letter. IRM 7668.3(1) states:

> "Under the provisions of section 170 of the Code, donors may deduct contributions to you if made for the use of a State, possession of the United States, any political subdivision of the foregoing, the United States or the District of Columbia, if the contributions were made for exclusively public purpose."

3. Miscellaneous Issues

A. FICA/FUTA

Prior to The Social Security Amendments of 1983, P.L. 98-21, 97 Stat. 65, IRC 501(c)(3) organizations had no liability for FICA and FUTA taxes (Social Security/unemployment compensation) under IRC 3121 and IRC 3306, respectively, unless they elected FICA coverage. Public Law 98-21 mandated FICA (Social Security) coverage of employees of most IRC 501(c)(3)

organizations. FUTA (unemployment compensation) coverage was not so extended. Further complicating the question of coverage are the exceptions to FICA/FUTA coverages in IRC 3121(b)(7) and IRC 3306(c)(7), respectively. These sections provide that coverages will not be extended to employees of a state or any political subdivision thereof, or to an instrumentality of any one or more of the foregoing which is wholly-owned. The FICA/FUTA and wholly-owned issues are not within the jurisdiction of EO. Further, Social Security coverage for instrumentalities and political subdivisions is generally elective and is made pursuant to an agreement between the state and the Secretary of Health and Human Services under section 218 of the Social Security Act, 42 USC 418 et. seq. IRM 7668.3(2)(b) sets forth pattern paragraphs to be included in exemption letters under IRC 501(c)(3) on the issue of FICA/FUTA coverages.

B. IRC 103 - Interest on Certain Governmental Obligations

Instrumentalities that run large public facilities such as: universities, hospitals, public school districts, public utilities, industrial development or public works authorities, and a host of other entities require huge amounts of capital in order to carry out their activities. A favored method of raising such capital is long-term interest-bearing debt obligations backed, in whole or part, by the instrumentalities' revenues and legislatively authorized by the appropriate state or local government. Whether the sale of a particular long-term debt (bond) issue in the capital markets will be a success is often, if not always, dependent upon the monetary inducements or preferences attached to such long-term debt issue. One of the principal inducements is bond interest income which is free from the imposition of federal income tax.

IRC 103(a) provides an exclusion from gross income of the interest on any state or local bond. IRC 103(c) defines state or local bond to mean an obligation of a state or political subdivision thereof. State also includes the District of Columbia and any possession of the United States.

IRC 103(b) provides, in part, that the exclusion from gross income does not apply to a private activity bond which is not a qualified bond within the meaning of IRC 141.

IRC 141(d) defines qualified private activity bonds. One form of qualified private activity bond is described in section 141(d)(1)(G) as a qualified IRC 501(c)(3) bond.

IRC 145 describes qualified 501(c)(3) bonds. A bond is so qualified if (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bond will not be a private activity bond. Such bond will not be a private activity bond if: (A) 501(c)(3) organizations are treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and (B) no more 5-percent of the proceeds are to be used by some person other than the 501(c)(3) organization or governmental unit.

The Tax Reform Act of 1986 effectively cuts back on the prior Code exclusion. Tax-exemption for interest on qualified IRC 501(c)(3) bonds continues, provided that at least 95-percent of the net proceeds are to be used by no person other than an IRC 501(c)(3) organization or a governmental unit. Further, a bond is now not a qualified IRC 501(c)(3) bond if the bond would be a private activity bond (that is, if the IRC 501(c)(3) organization was treated as a governmental unit and more than 5-percent (rather than 25 percent under prior law) is devoted to private business use. Under the new Act, as under prior law, the use of bond proceeds by an IRC 501(c)(3) organization in an unrelated trade or business constitutes private use. See new IRC 145 generally for the requirements for qualified 501(c)(3) Bonds.

Further complicating the bond area is that IRC 103, and new IRC 141 through 150, also allow the so-called "composite issue" bond. This bond consists in part of an issue used to fund strictly governmental functions and in part to fund the activities of IRC 501(c)(3) organizations. Under new IRC 145 created by the Act, interest exclusion requirements for IRC 501(c)(3) qualified bonds differ from the interest exclusion requirements for other forms of governmental bonds. Varied and complex restrictions and requirements also apply to various types of activities funded through these bonds. The various types of bonds and requirements applicable to each are described in new Code sections 141 through 150.

Certain governmental instrumentalities, such as universities and hospitals are, of course, exempt under IRC 501(c)(3) and may have letters from the Service to this effect. The conference agreement indicates that bonds for these entities are to be treated as governmental bonds. On qualified IRC 501(c)(3) bonds, in a change from the prior law, the property which is to be provided by the net proceeds of the issue now must be owned by a 501(c)(3) organization or a governmental unit. See IRC 145(a). Also, there is imposed by The Tax Reform Act of 1986, a $150 million per organization limitation on non-hospital bonds. See new IRC 145(b).

There are also some instances of bond funding of hospital and related non-hospital facilities (for example, a laboratory) out of the same bond issue. The tax reform act would apply the above limitation only to the non-hospital portion. Bonds for mixed use (hospital/non-hospital) facilities would be subject to an allocation formula prescribed by the Treasury Department. Finally, an election could be made not to treat such bonds as "qualified IRC 501(c)(3) bonds" and to thereby benefit from exempt facility bond and qualified redevelopment bond financing, subject to new state private activity bond volume limitations.

From the above discussion it should be clear that IRC 501(c)(3) exemption may be of great importance to an instrumentality for reasons other than tax exemption. EO Specialists should therefore scrutinize applications with care because of possible ramifications beyond that of tax-exemption under IRC 501(c)(3).

4. Lessening the Burdens of Government

A. Current Standards

Lessening the burdens of government is a separate, independent basis for exemption under IRC 501(c)(3) set forth in section 1.501(c)(3)-1(d)(2) of the regulations which defines "charitable" for purposes of IRC 501(c)(3). The concepts of instrumentality of government and lessening the burdens of government are separate and discrete, but must often be considered together. An organization that claims "lessening the burdens of government" as its basis for exemption may be so closely related to the governmental entity it serves that it would be unable to meet the "separate entity" requirement of Rev. Rul. 60-384, discussed in the first part of this topic. Cases involving organizations lessening the burdens of government may be worked in the field, whereas instrumentality issues must be referred to the National Office under IRM 7664.31(3).

The standard for lessening the burdens is the determination that a governmental burden exists (as evidenced by the government), and that the organization's activity actually lessens that burden. Both of these determinations are based upon the facts and circumstances of the case.

B. New Revenue Rulings

Two newly-published revenue rulings provide guidance in the area. These revenue rulings are Rev. Rul. 85-1, 1985-1 C.B. 177, and Rev. Rul. 85-2, 1985-1 C.B. 178 reproduced below:

Subpart F.--Exempt Organizations
Part 1.--General Rule

Section 501.--Exemption From
Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Charitable organization; lessening governmental burdens; funding for law enforcement. An organization that provides funds to a county's law enforcement agencies to police illegal narcotic traffic lessens the burdens of government and, therefore, qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 85-1

ISSUE

Under the circumstances described below, does an organization that provides funds to a county's law enforcement agencies to police illegal narcotics traffic qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

Organization S, which otherwise qualifies for exemption from federal income tax under section 501(c)(3) of the Code, was created to assist County B's law enforcement agencies in policing illegal narcotics traffic more effectively. S provides funds that allow B's undercover narcotics agents to buy drugs in the course of their efforts to apprehend persons engaged in illegal drug traffic. No government funds are otherwise available for these purposes.

S plays no part in the apprehension or criminal prosecution of drug dealers engaged in illegal drug traffic other than making funds available to B's law enforcement agencies. S's officers include B's district attorney, sheriff, and medical examiner. S is supported by contributions from the general public.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense, and includes the lessening of the burdens of government.

Rev. Rul. 74-246, 1974-1 C.B. 130, holds that an organization assisting a police department in the apprehension and conviction of criminals by making funds available for use in offering rewards qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 85-2, this page, this Bulletin, holds that an organization formed to train and provide legal services to volunteer guardians ad litem qualifies for exemption under section 501(c)(3). The criteria set out in Rev. Rul. 85-2, for determining whether an organization's activities are lessening the burdens of government are: first, whether the governmental unit considers the organization's activities to be its burden; and second, whether these activities actually lessen the burden of the governmental unit. An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances.

S funds activities that B treats as an integral part of its program to prevent the trafficking of illegal narcotics. B thereby demonstrates that these activities are a part of its burden.

That S is lessening the burdens of B is shown by the fact that the government is enabled to augment its law enforcement

activities in the area of illegal drug traffic. B's law enforcement agencies can engage in certain aspects of drug enforcement without the appropriation of additional governmental funds. Thus S is lessening the burdens of government within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations.

HOLDING

The organization described above, which provides funds to a county's law enforcement agencies to police illegal narcotic traffic, qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023. Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Charitable organization; lessening governmental burdens; legal assistance for guardians ad litem. An organization that provides legal assistance to guardians ad litem who represent abused and neglected children before a juvenile court that requires their appointment lessens the burdens of government and, therefore, qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 85-2

ISSUE

Under the circumstances described below, does an organization that provides legal advice and training to guardians ad litem representing neglected or abused children before a juvenile

court qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code?

FACTS

The organization, which otherwise qualifies for exemption from federal income tax under section 501(c)(3) of the Code, was created and is operated for the sole purpose of providing legal counsel and training to volunteers who serve as guardians ad litem in juvenile court dependency and deprivation proceedings. This activity is part of a program operated by the juvenile court of a particular community. In the program, volunteers are recruited and selected from the community at large and are appointed by the court to serve as guardians ad litem in cases involving neglected or abused children. The volunteer's function is to investigate the facts of the case, to provide the court with a comprehensive evaluation of the problem, and to provide a recommendation on what course of action would be in the child's best interest.

The law of the State in which the organization is incorporated authorizes, and the local court's rules of practice require, the appointment of a guardian ad litem to represent a child's interest in a proceeding relating to child abuse. For several years prior to the implementation of the volunteer program, the court appointed and paid attorneys to serve as guardians ad litem and represent the children in court proceedings. The court was experiencing problems in the appointment of attorneys and decided to initiate the volunteer program.

The organization employs attorneys to provide legal advice and representation to the lay volunteers, and operates a training program for the volunteers on how best to represent the interests of abused and neglected children. The organization is supported in part by grants from the juvenile court.

LAW AND ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense, and includes lessening the burdens of government.

A determination of whether an organization is lessening the burdens of government requires consideration of whether the organization's activities are activities that a governmental unit considers to be its burdens, and whether such activities actually "lessen" such governmental burden.

To determine whether an activity is a burden of government, the question to be answered is whether there is an objective manifestation by the government that it considers such activity to be part of its burden. The fact that an organization is engaged in an activity that is sometimes undertaken by the government is insufficient to establish a burden of government. Similarly, the fact that the government or an official of the government expresses approval of an organization and its activities is also not sufficient to establish that the organization is lessening the burdens of government. The interrelationship between the organization and the government may provide evidence that the government considers the organization's activities to be its burden.

To determine whether the organization is actually lessening the burdens of government, all of the relevant facts and circumstances must be considered. A favorable working relationship between the government and the organization is strong evidence that the organization is actually "lessening" the burdens of the government.

In this case, the juvenile court requires the appointment of guardians ad litem. The court previously undertook to appoint and compensate attorneys to serve as guardians in juvenile court proceedings. After several years of this practice, the court determined that the best way to conduct this activity would be to appoint volunteers and arranged with this organization for the training and legal representation of the volunteers. The court supports this organization through grants and utilizes the volunteers trained by the organization. These facts show that the government considers the activities of the organization to be its burden.

The organization's training of lay volunteers is an integral part of the government's program of providing guardians ad litem in juvenile court proceedings. Without the organization's activities, the government could not continue its present program, unless it undertook to train lay volunteers itself, or appointed attorneys to act as guardians as it had in the past. Thus, the organization is actually lessening the government's burden within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations.

HOLDING

The organization described above, which provides legal advice and training to guardians ad litem representing abused or neglected children before a juvenile court, qualifies for exemption from federal income tax under section 501(c)(3) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. See sections 1.501(a)-1 and 1.508-1(a) of the regulations. In accordance with the instructions to Form 1023, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

Rev. Rul. 85-2, supra, sets forth the basic criteria of the two-part tests and applies the criteria to an organization providing legal assistance to guardians ad litem. Rev. Rul. 85-1 applies the criteria to organizations which assisted the police with funds to suppress the trade in illegal narcotics. In both revenue rulings the explicitly stated standards were met and the organizations qualified for exemption under IRC 501(c)(3).

With the issuance of these revenue rulings, sufficient precedent exists to rule on most cases involving lessening of the burdens of government, and jurisdiction has been returned to the field.